Mr. Chairman and Members of the Committee:

As a member of the baby boom generation, I grew up with individuals who, whether conservative or liberal, considered themselves idealists when it came to the role of the federal government. They might have disagreed over the optimal size of government or the degree of taxation, but they did believe that government should serve its citizens well and should promote civil rights, defend against totalitarianism, and provide opportunity, especially to the poor. Today this cohort has come into full power as members of the labor force, of the business community, of the White House, and of Congress itself. *It is ironic that the legacy that baby boomers would now bequeath is one in which almost the sole purpose of the federal government would be to care for their own consumption needs in retirement.*

I do not believe this legacy is intended. Yet it would come about under current law, under the President's proposals, and under many of the Republican and Democratic budget alternatives now being considered in Congress. It is largely the consequence of laws written decades ago that pretend to determine almost all of the spending priorities for this Congress, as well as for future generations. In particular, it is the consequence of designing Social Security and health programs so that they forever grow faster than the economy, without regard to changes in fertility and mortality rates and other factors that determine the numbers of taxpayers and beneficiaries.

The total economic burden of this entitlement system depends mainly on how much of national and governmental resources it absorbs over time. As a matter of economics, different financing options may have only moderate effects on that burden. According to both the Administration and the Congressional Budget Office, Social Security, Medicare, and Medicaid together are estimated to rise from about 40 percent of revenues today to about 90 percent in the future. While much of this growth occurs once the baby boomers start retiring, the share of revenues available for other domestic priorities is already in a state of decline. In my view, it would not be helpful simply to pre-commit or earmark more revenues to try to catch up to promised spending that itself may not be viable. Such a use of general revenues could mislead, deter attention to society's greatest needs, and delay any reform efforts required.

If reform were to involve the building of a viable and balanced system unlikely to rely upon future deficit spending, on the other hand, a case could be made that general funds be used to "pay" for part of that reform. Even then, I would urge a great deal of caution. Broadly speaking, in the presence of real reform, the primary question switches from one of sustainability and balance to whether the structure we end up with years down the road represents good budget, expenditure, and tax policy. Spending general revenues temporarily to attain a sustainable Social Security system, for instance, still means not spending general revenues on education, or the environment, or defense. However, unique problems and needs sometimes require an infusion of funds. If reform also means that people work longer or save more, then they will also contribute more tax dollars that can be shared among various societal needs. But earmarking general revenues -- especially if the earmarking is perpetual, rather than temporary -- means telling future Congresses that they can't ever allocate some share of general revenues for other purposes.

Earmarked general revenues in a program that pretends to use its own tax source and engages in trust fund accounting, moreover, is confusing. It can easily encourage deficit financing -- perhaps permanent deficit financing -- of the program. Therefore, I conclude that if general funds are used, they should finance some particular program itself (e.g., a workable type of retirement savings account or some private pension incentive) or temporarily finance movement to some new regime, but not be made a permanent part of a trust fund program supposedly financed out of its own revenue source.

Suppose, however, that there is an increase in revenues due to more work -- e.g., under a reform that involves some increase in the retirement age. It would be tempting to allocate all of those additional general revenues to Social Security. Certainly, when reform proposals are compared, all the changes in the budget that they achieve, including any increases in general revenues, need to be compared on a consistent basis. This was one of the recommendations of the Technical Panel on Social Security that I recently chaired. Unfortunately, the upcoming decline in workers relative to retirees is not just a problem of financing for Social Security. It also affects Medicare. It affects Medicaid long-term care expenses. But it also affects education, environmental programs, defense, and every other budget item as well. More work as we live longer, I believe, will inevitably be one of the adjustments we will make as a society, one way or the other. But if we live longer, we also have obligations to help pay for public goods other than transfer payments in old age. Once again, then, I conclude that any general revenue transfer should not be made perpetual in nature, but should help finance the transition to a balanced system.

Background -- A Hybrid System Already

It is difficult, however, to be a purist about general revenue financing. Programs for the elderly and near-elderly are already partially financed directly and indirectly through general revenues. Examples include: the financing of Part B of Medicare out of general revenues; the transfer at times of benefits from Medicare Part A to Part B so that Part A appears more solvent; the expansion of long-term care for the elderly within Medicaid (or, as the President proposes, with income tax credits) rather than as part of a broader reform of the health care benefit package offered as a whole to the elderly; the use of Supplemental Security Income (SSI) to pay for some transfers to low-income retirees even though other large transfers occur within Social Security; the income tax exemption for one-half of Social Security taxes paid, along with the exemption of most Social Security benefits from income taxation; and the transfer to Social Security of income taxes (general revenues) paid on benefits on the basis of a very generous formula for calculating what is paid. In fact, despite moderate temporary "surpluses" in some Trust Funds, programs for the elderly today would be running substantial deficits if these sources of general revenues were not counted.

Historically, Social Security has also had some general revenue infusions to cover the cost of military service wage credits (1956), transitional benefits for those aged 72 and older with fewer than three quarters of coverage (1966), wage credits for U.S. citizen internees of Japanese ancestry (1972), and for taxes which would have been collected on deemed post-1956 military service wage credits (1983).

Despite the many general revenue sources already used in elderly and near-elderly programs, a good case can be made that the remaining tie between taxes and benefits, as reflected in the concept of trust fund balances, is a source of fiscal discipline and does help prevent further deficit financing, at least in Social Security. Reform in 1983 would be an example of benefit reductions and tax increases forced by the projected inability of trust fund revenues to meet trust fund obligations. The trust fund concept and the calculation of trust fund imbalance also seems to be a driving force for reforming Social Security today.

General Fund Transfers in the Absence of Reform

In the absence of reform aimed at achieving a balanced system, general fund transfers might actually discourage making the tough choices required. If so, they would likely add to long-term deficits both in the unified budget and in Social Security, Medicare, or other programs receiving the transfers. In the case of Social Security, general fund transfers with no overall reform would reinforce the misconception that the program has significant assets with which to pay out its liabilities. In fact, it is mainly a cash flow system with a very temporary modest cash surplus during the short period when the baby boom bust population of the Depression and World War II moves into the retirement population.

Merely making an additional transfer from the government's left hand (Treasury) to its right hand (Social Security) -- over and above any surplus accruing between taxes and benefits - masks too much. The simple fact is that future taxpayers must cover the cost of the interest and principal on any gift of bonds from Treasury to Social Security.

The Issue of Saving

It is possible, of course, that some general fund transfers now might encourage more short- run saving by government -- reducing future interest costs. This is one of the arguments used by the Administration. In its own proposal, success depends upon transferring bonds to Social Security in a way that would effectively reduce current non-Social Security spending and/or tax reduction by the amount of additional bonds turned over today. Then, later, the additional interest and principal paid from Treasury to Social Security would again reduce the measure of non-Social Security surplus, further reducing the tendency to spend it. Much confusion reigns over this proposal, but consider it in two pieces. First, bond transfers today would be treated almost like current expenditures, so that when Congress aims for targets like a zero-deficit in the non-Social Security budget, less will be left over for other tax cuts or spending items. Second, over the long-run the same amount of resources is required for Social Security and other entitlements, only now more is "earmarked" through the additional interest and principal "owed" to Social Security because of the bond transfers. Any current saving will also reduce the interest costs, thus leaving a tiny bit more for other purposes down the road. Also not to be forgotten here is that the Administration proposes to subsidize retirement saving accounts also attempts to direct some of the current surplus toward encouraging saving relative to alternative budget uses.

We must distinguish, however, between the short-run issue of how to limit surplus spending now with the longer-run issue of how future Presidents and Congresses might be constrained. Let's be clear: neither the Administration nor Congress at this point is contemplating saving more than current law implies. On the contrary, they anticipate a significant reduction in what used to be called the primary surplus or deficit (which excludes interest). Thus, both sides of the aisle are considering how to remove discretion from future Congresses by trying to allocate today future surpluses expected for tomorrow -- usually before those surpluses are realized and before the needs of tomorrow are fully known.

The Administration's proposal also attempts somehow to put future Presidents and Congresses under a regime where the accounting switch or bond transfers will lead to a smaller measure of the non-Social Security surplus in exchange for a smaller measure of future Social Security deficits. The net result, however, is that it creates confusion for both discretionary and entitlement spending. Funds available for discretionary spending appear smaller, but discretionary spending is already projected at what most believe to be unrealistically low shares of total revenues (see Figure). Social Security, in turn, appears to be running smaller deficits than when own-source revenues are compared to expenditures.

Other Structural Issues Raised When Social Security and Other Entitlements Are Financed by General Revenues

If general revenue financing were to become more pervasive, other important public finance issues will come to the fore. Although these issues have received scant attention, movement toward general revenue financing would almost assuredly force future Congresses to address them as well.

Should an individual's Social Security benefits be based on his or her own contributions or earnings subject to Social Security tax?

Advocates of today's Social Security system have long argued that benefits are an earned right because one's Social Security taxes helped pay for those benefits. Although never strictly correct, general revenue financing cleanly breaks the relationship between benefits and taxes on earnings alone. The more formal introduction of significant general revenue financing into Social Security would shift public sentiment further toward viewing the system as a transfer program rather than a program paid for out of "contributions." The Administration, moreover, has hinted in the past that some of the remaining imbalances in Social Security (and Medicare) could be met by further gifts of bonds from Treasury beyond what they have proposed. Hence it suggests that the general revenue financing door can be opened even further by this or later Congresses. In a system of transfers from general revenues, the notion that one is entitled to some benefit because he or she has paid a mandate withers away.

An example of the type of issue that will arise is whether or not Social Security should be means-tested. Many transfer programs financed out of general revenues are means-tested. While I generally conclude that means-testing of a substantial portion of the elderly population is hard to police, could be considered degrading, and would discourage saving for retirement, it is among those options likely to be put on the table once general revenue financing becomes more prevalent.

What is the right tax?

Another important public finance question is what is the appropriate tax or combination of taxes to support old age programs -- wage taxes, income taxes, or consumption taxes. Although we have already noted many exceptions, a wage tax is still considered the appropriate source of revenues for Social Security and Medicare. General revenue financing re-opens this debate. As only one example, a case can be made for consumption taxation vis-a-vis wage taxation if, as projected, we continue on a path where larger and larger portions of Social Security and Medicare recipients consume at higher rates than many of the workers who pay for those transfers. By the same token, it is doubtful as a matter of simplicity -- yes, there are a few of us left who care about simplicity -- that one would want to add yet another tax system onto the ones we already have.

Summary

In summary, we have only begun our journey toward a domestic policy in which our children are allowed some choice and discretion as to what their government will do. Getting our budget into surplus after years of large deficits has been a positive development, but only a step along the way. We still have in place laws that would obligate the children of today to pay almost all of their future federal taxes as transfers to support the consumption of their parents. This is not a recipe for efficient or citizen-led government. The path we are on, I believe, is already deterring us from allocating government resources to society's most pressing needs.

Done the right way, the infusion of some general revenues into a Social Security reform package might help deal with some of the political pain of attaining a balanced and sustainable system. Certainly more saving by government -- or limited reduction in projected surpluses -- is also a prudent move. Development of ideas such as subsidized retirement saving accounts, just like other individual account proposals, offers the prospect of addressing the very poor distribution of private pension wealth in society.

Nonetheless, additional general revenue financing of Social Security in absence of broader reform tends to hide the true deficits in Social Security, deter reform, and likely increase total government deficits in the long-term. It is also unclear how much any poorly understood budget accounting shift, even if it passed this Congress, could be placed off-bounds for re-consideration by future Presidents and Congresses. If more general revenues are used for Social Security reform, I conclude that they should either finance some temporary transition to a sustainable system or a general revenue program related to private pensions or a well-designed retirement saving program.

APPENDIX 1

The Nature of Future Obligations

A few examples convey the extraordinary nature of our future obligations, whether financed out of Social Security taxes or general revenues.

- Using today's prices, an average-income couple retiring in 1960 could expect to receive about $100,000 in lifetime Social Security benefits. A typical couple retiring today would receive about $1/2 million in Social Security and Medicare benefits (about equal amounts of each). Average-income baby boomer couples, on the other hand, would receive around $3/4 million, and those who come later are scheduled to receive as much as $1 million (in today's dollars). General revenue financing does not change that level of obligation.

- The number of workers per beneficiary is currently scheduled to drop from more than 3-to-1 to less than 2-to-1. Out of every dollar in cash wages, the government already requires workers to pay 15 cents in Social Security tax, plus several cents in general revenues, to support elderly and disability programs alone. In the future that rate of tax could increase substantially -- 5 to 6 percentage points alone due to Social Security. General revenue financing only changes what type of tax will support those elderly programs.

- One reason for these rising costs is that Social Security and Medicare dictate that successive generations should receive higher levels of real benefits than all previous generations. For example, baby boomers are told that, regardless of other needs of the population, they are entitled to receive higher levels of real benefits from their children than they, the baby boomers, transferred to their parents -- that this is an entitlement. General revenue financing does not change these scheduled increases in benefits.

- Another reason that Social Security and other retirement programs take ever larger percentages of national income is that people are living longer and spending more years in retirement -- almost a decade more than Social Security retirees in the early years of the program. *Today individuals claim an entitlement to retire on Social Security for almost one-third of their adult lives*. More years of retirement also reduce the number of taxpayers for both Social Security and other purposes, thus raising tax rates on those still working. General revenue financing does not change this trend.

- Within a few decades, *close to one-third of the adult population will be receiving SocialSecurity benefits under current law*. Add to those numbers the unemployed or unemployable, or those on other assistance programs, and a substantial portion of the adult population will be largely -- in many cases, primarily -- dependent upon the children of today to support them through their tax dollars. Of course, our children will need to support their own families, as well, but the share of the budget available to meet the educational, environmental, health research, urban, justice and other needs of our children and grandchildren would be drastically reduced. General revenue financing simply reinforces that pressure.